Supreme Court, U.S.
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No. 02-1389

In the

Supreme Court of the United States

UNITED STATES,

Petitioner,

v.

ABEL COSMO GALLETTI and SARAH GALLETTI;
FRANCESCO BRIGUGLIO and ANGELA BRIGUGLIO,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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RESPONDENTS' QUESTION PRESENTED

Whether the United States must, within three years after the return was filed, either make a separate assessment against the partners individually or bring a court proceeding directly against the partners, to enforce the liability of partners for unpaid partnership payroll taxes pursuant to California law?

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COUNTER-STATEMENT OF THE CASE

The Gallettis and the Briguglios ("Respondents") were general partners of Marina Cabrillo Partners ("the partnership"). From 1992 through 1995, the partnership failed to pay the total due in federal employment taxes, and the Internal Revenue Service ("IRS") made timely assessments against the partnership pursuant to 26 U.S.C. 6203.

The Respondents filed voluntary Chapter 13 Petitions in the Bankruptcy Court. The IRS filed Proofs of Claim in the Respondents' personal bankruptcy cases in early 2000 to recover the unpaid federal employment taxes owed by the partnership, almost eight years after the taxes were first due; $395,006.37 against the Gallettis and $427,402.74 against the Briguglios. Over 60% of the claims were for interest and penalties accrued these many years. Pet. App. p.19a, 32a.

The Respondents objected to the claims on the grounds the IRS had assessed only the partnership, not the individual partners, and that the statute of limitations for assessment or filing suit had run. The Respondents agreed that under California Corporations Code §16306, all partners are liable jointly and severely for the obligations of the partnership; however, the judgment against a partnership could not be satisfied from an individual partner's assets unless a judgment had been obtained against the partner. California Corporations Code §16307(c). Pet. App. p.15a, 50a.

The government asserted that its assessment against the partnership was timely and extended the time for collection of the taxes from the Respondents individually.

The Bankruptcy Court sustained the Respondents' objections to the IRS' Proof of Claims because the IRS had failed to assess the partners individually within the three year period provided by 26 U.S.C. 6501. Pet. App. p.62a-67a.. The District Court and the Court of Appeals affirmed the Bankruptcy Court's decision. All of the lower courts concluded that since the IRS had not obtained a judgment against the Respondents and the time for filing suit had expired, the

individual partners could not then be held liable for the tax debt of the partnership pursuant to California law.

REASONS FOR DENYING THE WRIT

The decision by the Ninth Circuit Court of Appeals is correct. The IRS has correctly applied California law to determine liability of the individual partners for the partnership debt, but has failed to consider the requirement of a prior judgment before proceeding with collection as California law requires.

The IRS' argument fails to apply this Court's reasoning in *Jersey Shore State Bank, v. U.S.*, 479 U.S. 442 (1987) which implies that assessment and notice is required for partner derivative liability prior to collection under principles of fairness and due process absent mitigating factors (such as are present in derivative liability of a lender who provides funding for wages).

The IRS also overstates the conflict between the Courts of Appeal. The cases which have been cited in Appellant's Petition are clearly distinguishable. The apparent conflict can be readily explained.

I.
THE IRS FAILS TO DISTINGUISH BETWEEN LIABILITY AND COLLECTABILITY

A. The IRS has agreed that California law makes individual partners liable for partnership debt but fails to acknowledge that California law requires a judgment against the individual partner to satisfy partnership debt from the partner's assets.

In 1968, the California Supreme Court solidified the doctrine that no judgment for a partnership debt can be rendered against an individual partner without that partner being individually named and served in the lawsuit. *Fazzi v. Peters*, 68 Cal. 2d 590 (1968). This decision was based upon the common law principle that a judgment may not be entered either for or against one who is not a party to an action. This rule of law has been codified under California Corporation Code §16307(c). This principle is a matter of procedural due process. "A contrary rule would raise constitutional problems." *Valley National Bank of Arizona v. A.E. Rouse & Co.*, 121 F. 3rd 1332, 1336 (9th Cir. 1997). This principle has also been recognized in the Fifth Circuit which found that the liability of a partner requires a legal proceeding in which the individual partner is personally served with process or notice so that he has an opportunity to contest the claim on its merits. *Detrio v. U.S.*, 264 F. 2d 658, 661 (5th Cir. 1959). The IRS cannot base its right to collect against a partner's assets on state law principles and then ignore the state law due process requirements for collection.

B. An assessment is the equivalent of a judgment.

This Court has said: "[T]axes are the life-blood of government and their prompt and certain availability an imperious need..... the assessment is given the force of a judgment, and if the amount assessed is not paid when due, administrative officials may seize the debtor's property to satisfy the debt.....The assessment supercedes the pleading, proof and judgment necessary in an action at law, and has the force of such a judgment." *Bull v. U.S.*, 295 U.S. 247, 260 (1935). "The purpose of an assessment is to place the amount of taxes owed by the taxpayer on the government's books. It does not create the tax liability, but merely operates in the nature of a judgment and this allows for collection of the tax liability." *Doerge v. U.S.*, 181 B.R. 358, 363 (S.D.Ill. 1995). State law determines liability. Assessment starts collection. The IRS has the option of proceeding without assessment by filing a lawsuit against the individual partners within three years after the return was filed. 26 U.S.C. 6501(a). If the IRS chooses the assessment option pursuant to 26 U.S.C. 6502, the IRS has an additional ten years after the assessment to collect by levy or by proceeding in court. This could result in a thirteen year period, after the return was originally filed, before the IRS brings a lawsuit or moves to collect the taxes as well as interest and penalties which have been accruing this entire period.

The law provides certain procedural due process safeguards for the taxpayer when the IRS chooses to use the assessment option. Assessment triggers these procedural safeguards. Pursuant to 26 U.S.C. 6303, within sixty days from the date of assessment, the IRS is

required to provide the assessed party with notice of the assessment and demand for payment. Under §6203, the assessed taxpayer has the right to demand a copy of the record of assessment. A taxpayer has only ninety days after the notice of deficiency is mailed to petition a tax court for a redetermination of the amount assessed pursuant to 26 U.S.C. 6213. A taxpayer who is not separately assessed, or does not know that a particular entity with which he or she was related has been assessed, may loose these rights including the right to challenge the assessment in tax court. 26 U.S.C. 6213(c). Without the §6203 notice following assessment, years may go by as interest and penalties mount drastically before a partner finds out that his or her former partnership has been assessed. The IRS has ten years from assessment to collect these taxes by lien or levy without further warning.

A policy of both (1) concern for fairness and (2) consideration for procedural due process has been the impetus for Congress to establish these statutory protections within the IRS Code ("IRC"). These same concerns are evident in state law which requires notice and an opportunity to defend before a partner's individual assets can be attached in satisfaction of partnership debt. The IRS's interpretation of the law would remove these protections which were clearly provided by the legislature.

II.
THE IRS' ARGUMENT WRONGLY APPLIES THIS COURT'S REASONING IN *JERSEY SHORE* WHICH IMPLIES THAT ASSESSMENT, NOTICE, AND DEMAND ARE GENERALLY REQUIRED FOR DERIVATIVE LIABILITY.

In *Jersey Shore State Bank v. U.S.* 479 U.S. 442, (1997) this Court, in a unanimous opinion, examined whether the government must give post assessment notice and demand for payment pursuant to §6303(a) to a lender liable for the repayment of employment taxes. Congress created a special statutory scheme to establish liability against lenders and sureties who loaned funds to employers for the sole purpose of paying wages. Pursuant to §3505(a), if a lender or surety who is not an employer pays wages directly to an employee at the request of the employer, that lender or surety is liable directly to the government in an amount equal to the taxes plus interest which should have been deducted and withheld. The lender is not liable for the employer's share of unpaid social security taxes. Pursuant to §3505(b), if the lender or surety supplies funds to the account of an employer for the specific purpose of paying wages to the employees, with "actual notice or knowledge" that the employer will not pay the withholding taxes, the lender or surety is liable for the withholding tax which was not paid plus interest *but only up to 25% of the amount supplied to the employer.*

This Court resolved a conflict between the circuits and found that §6303(a) notice and demand was not required prior to instituting a civil action against the lender pursuant to §3505. This Court's entire opinion was predicated upon an analysis based upon *fairness.* The Court decided it was not *unfair* that a tax liability

notice under §6303(a) be given to the employer but not the lender, because the employer is subject to the government's summary collection procedures, but the IRS can only collect against the lender by filing a civil suit. Thus, this Court reasoned that the employer has a far greater need for an assessment notice than third-party lenders who are not subject to summary collection.

This Court also noted that a §6303(a) notice may not be particularly applicable to a third-party lender because the notice only states the total amount of overdue taxes assessed against the employer which may very well be far greater than the actual liability of the lender under §3505. The lender's liability would equal the amount under the notice only when the lender provided payroll financing throughout the entire time period indicated in the assessment, and then it would probably overstate the amount due if the lender were liable under §3505(b) which limits the lender's exposure to 25% of the funds supplied to the employer. In addition, this Court considered that a lender would not be liable under §3505 "unless it either 'pays wages directly' to an employee or supplies funds for the wages with 'actual notice or knowledge' that the employer is either unable to make timely payment of the required withholding taxes or has no intention of doing so." *Jersey Shores* at 448. Therefore, the lender could be alerted to its liability when it first began providing funds for payment of employee "net wages" but not providing funds for payment of withholding taxes. The lender could protect itself against future liability by including such amounts in its loans and taking adequate security. It also could establish its premiums considering this risk of liability.

This Court's analysis was based on the finding of the above special mitigating *fairness factors* which are not present in the derivative liability of partners for partnership debt. The IRS can seek enforcement against partners by either summary collection procedures or by filing a civil suit. Unlike a lender, it is not necessary that the IRS show that a partner paid wages directly to partnership employees or had actual notice or knowledge that the partnership employer did not intend to pay the taxes. Further, there are no liability limitations to a partner, so a §6303(a) notice would accurately reflect the partner's liability (unlike a lender). Notice would provide the partner with due process and enable the partner to dispute the debt both administratively and in tax court.

If assessment, notice and demand were not required to enforce all types of derivative liability (including partner liability) as the IRS argues, one could infer that this Court's analysis involving fundamental fairness would not have been necessary for §3505 liability in *Jersey Shore*.

III.
THE GOVERNMENT'S ASSERTION THAT THERE IS A DISPARITY AMONGST THE COURTS OF APPEAL IS MORE ILLUSORY THAN REAL

The Ninth Circuit Court of Appeals found that: "A judgment against a partnership is not by itself a judgment against a partner. A judgment against a partnership may not be satisfied from the partner's assets unless there is also a judgment against the party." Pet. App. p.16a citing Cal. Corp. Code §16307(c). Therefore, although each individual partner is liable for the debts of the partnership under California law, a

claim against the partnership does not automatically give rise to a right to collect against the individual partners. The creditor must first obtain a judgment against the partner before collecting on the debt for which the partner is jointly and severely liable. Pet. App. p.16a. Liability and collectability are not congruous.

The Government asserts, Pet. p.7, that the Fifth Circuit. is in disagreement and cites *Remington v. United States*, 210 Fed. 3rd 281 (5th Cir. 2000). The issue in *Remington* was whether the penalty provision for responsible parties pursuant to 26 U.S.C. 6672 preempted state law making partners jointly and severally liable for partnership debts. The partner argued that he was not the responsible party and, therefore, not liable. The Fifth Circuit found that §6672 is a "catch all," and applies in addition to other tax code provisions. Section 6672 does not preempt state law. *Remington* merely holds that partners, whether responsible parties or not, may be liable for withholding taxes of the partnership. This issue is not in dispute here. The issue in the case at bar is whether or not the IRS can proceed against an individual partner for collection of partnership debt, after the three year statute of limitations has run, without assessing the individual partner? The record doesn't indicate whether the IRS assessed the taxes against the partner individually in *Remington*. That was not before the Court. The Fifth Circuit had decided *Detrio v. U.S.* 264 F. 2d 658 (5th Cir. 1959), a case for recovery of excess partnership profits pursuant to the War Contracts Renegotiation Act, in which the Government sought payment from a former partner individually. The Fifth Circuit said: "In partnership law the establishment of the personal unlimited liability of the general partner

requires a legal proceeding in which (whether local practice requires him to be named personally or not) the individual partner thus pursued is personally served with process or notice. This is so because he must have an opportunity to contest the claim on its merits." *Id.* at 661. The Fifth Circuit found that the partner was never served with any notice of the proceedings, yet the government knew the name and residence of each of the partners. Therefore, adhering to the principles of procedural due process, the partner could only be liable to the extent he held partnership assets and could not be divested of his personal assets.

The Government cites the Seventh Circuit case of *U.S. v. Wright*, 57 F.3d 561 (7th Cir.) in support of their assertion of conflict between other courts of appeal and the Ninth Circuit. The issue in *Wright* was whether the statute of limitations should be tolled as to the individual partner during the pendency of a bankruptcy filing by the partnership alone. The record in the District Court case, *U.S. v. Wright*, 868 F. Supp. 1070 (S.D.Ind 1994), indicated that the assessments were made against the partners as well as the partnership. The Seventh Circuit held the statute of limitations had been tolled against both the partnership and the individual partners, during the partnership's bankruptcy, but it did not address the assessment issue. The Ninth Circuit discussed the *Wright* case in the opinion below and found that it was not applicable because assessment had been made and notice given to the partners individually.

The Tenth Circuit case of *U.S. v. Botefuhr*, 309 F.3d 1263 (10th Cir. 2002) involves the application of §6502 to §6324 which imposes liens for estate and gift tax deficiencies. The policy behind §6324 liability is

entirely different from that underlying partner liability for partnership debt. Under §6324, the donee assumes liability to the extent of the value of the gift already received. Since the tax is limited to a gift already received, the donee should be aware of potential tax liability and would be no worse off than the loss of property already received. However, partners have unlimited liability for partnership debt and without assessment, notice and demand individually directed, individual partners would have no opportunity to contest the amount of the tax debt. They would be subject to unlimited administrative collection against the entirety of their personal assets.

The Government attempts to mislead and confuse this Court in their analysis of the lower court decisions by pretending that there is only one limitation period applicable in this case. The Government attempts to focus solely on the ten year collection period pursuant to 26 U.S.C. §6502 (which is not at issue in this case). They completely ignored the three year assessment or notice period under 26 U.S.C. §6501 (which is the major issue in this case). The Government claims that assessment against the partnership extends the limitation period for collection to ten years. However, as the Ninth Circuit has correctly found, the assessment against the partnership extended the collection period against the partnership only. Pet. App. p.16a.

CONCLUSION

Before the Government can collect a tax debt against a liable party, the Government must first provide notice to all parties who may be liable. Congress has

determined that this notice may be provided by way of an assessment, by the filing of a civil action, or by the imposition of a penalty against a "responsible party" under IRC §6672. Other than liability pursuant to IRC §3505 (against a lender or surety who provides funds for the payment of wages), the IRS must, prior to commencement of tax collection against a liable party, provide notice, pursuant to section 6501, within the three year period after the return was filed. There is no dispute that the IRS failed to use any of these three methods to timely provide notice of the tax debt to the Respondents. There is also no dispute that the three year assessment and notice period ran prior to the commencement of the Respondents' bankruptcies. Thus, the IRS claim was time barred before the underlying Respondents' bankruptcies, and the IRS's claims were properly disallowed by the Bankruptcy Court.

The policy in favor of fundamental fairness and Congress's concern for procedural due process led to the present statutory scheme embodied in the Internal Revenue Code. The Ninth Circuit's careful analysis of the provisions in the IRC reveals that individual partners derivatively liable for partnership debt must be assessed as "taxpayers" and given notice and demand for payment prior to summary collection of their assets and prior to the extension of the statute of limitations for an additional ten years for either a law suit or administrative collection, without any notice whatsoever.

As Plato counseled at the end of the last book of *The Republic*: "pursue justice with wisdom in every way." Respondents ask no less of this Court and ask that the Government's Petition for Writ of Certiorari to

the Ninth Circuit be denied in the interests of fundamental fairness and concern for procedural due process, as the law justly demands.

RESPECTFULLY SUBMITTED,

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APPENDIX A
STATUTORY APPENDIX

1. 26 U.S.C. §6303 provides, in relevant part:

(a) General Rule

Where it is otherwise not provided by this title, the Secretary shall, as soon as practicable, and within sixty (60) days, after the making of an assessment of a tax pursuant to section 6203, give notice to each person liable for the unpaid tax, stating the amount and demanding payment thereof. Such notice shall be left at the dwelling or usual place of business of such person or shall be sent by mail to such person's last known address.

2. 26 U.S.C. §6324 provides, in relevant part:

(b) Lien for Gift Tax

Except as otherwise provided in subsection (c), unless the gift tax imposed by chapter 12 is sooner paid in full or becomes unenforceable by reason of lapse of time, such tax shall be a lien upon all gifts made during the period for which the return was filed, for 10 years from the date the gifts are made. If the tax is not paid when due, the donee of any gift shall be personally liable for such tax to the extent of the value of such gift.*******

3. 26 U.S.C. §6672 provides in relevant part:

(a) General Rule.

Any person required to collect, truthfully account for, and pay over any tax imposed by this title

who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.*****

(b) Preliminary notice requirement.

(1) In general. No penalty shall be imposed under subsection (a) unless the Secretary notifies the taxpayer in writing by mail to an address as determined under section 6212(b) or in person that the taxpayer shall be subject to an assessment of such penalty.